



Current and future monetary cooperation with a focus on the possible monetary union of Gulf Cooperation Council

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There is a lot of effort to create new monetary unions in the world. This paper focuses on the cooperation in the monetary field with a view to a possible monetary union of Gulf Cooperation Council. Some existing and proposed monetary unions are discussed in the paper. The focus is especially on the proposed monetary union among states of Gulf Cooperation Council (GCC). In the context of the emerging monetary union, countries of GCC are facing many challenges. The paper presents attempts of GCC countries to cooperate in the monetary field, barriers, benefits of the single currency and a couple of criteria by which can be assessed, whether a monetary union is the right step for this area. Some criteria of the Optimum Currency Area theory are applied to these countries here as well.

Keywords: monetary union, Gulf Cooperation Council, Optimum Currency Area theory, single currency

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1 Introduction

Monetary union is a group of two or more countries sharing a common currency or its equivalent (Cohen, 2003). There are also looser forms of monetary integration. For example, monetary union is also a group of countries, where the currency of one country is replaced by a currency of a stronger partner (US dollar is frequently used for this purpose – such an arrangement is called “dolarization”). It can be also an arrangement, when currencies of some countries are issued by national institutions but they are linked through fixed exchange rates. The example of monetary arrangement is also when one or more countries entrust monetary policy to one of the member countries. Such an arrangement is being considered with the establishment of monetary union among the countries of North American Free Trade Agreement (NAFTA). Some proposals have been considered that the competence in the field of monetary policy would shift to the Federal Reserve System.

From the historical perspective, there was not a broader monetary cooperation in the period of metallic monetary systems. The first monetary unions among independent countries formed in the 19th century. Currency unions were based on the cash circulation, i.e. coins and notes. Despite the fact that there are many examples of cooperation, most of them have been unsuccessful. The Latin Monetary Union is one of

these cases. Conversely, the successful monetary union was the German Monetary Union. By contrast, transnational monetary institutions and multilateral agreements in this field formed in the post war period.

Monetary unions in the world can be established because of various reasons. The political reasons are frequent and also typical when founding independent states, for example German Monetary Union since the year 1871 (forming of the German state) and formation of many other states, for example Switzerland, Italy. Other reasons for monetary unions are existential reasons. These reasons are typical for very small countries which accept the currency of a neighbouring state or an important business partner. Examples of these countries are Vatican, Monaco, Liechtenstein, Nauru, Kiribati, and El Salvador. Other important reasons for creation of monetary unions are also historical and economical reasons.

The criteria of theory of Optimum Currency Area (OCA) can be applied for the appreciation of the monetary union's suitability. The fulfilment of the criteria for OCA theory reduces the risk of asymmetric shocks or increases the ability of countries to face them. In accordance with this theory, the single monetary policy is suitable for countries exposed to symmetric shocks or disposing of flexible absorption mechanisms of asymmetric shocks. Therefore by OCA, we understand the grouping of countries within the benefits of membership in a monetary union outweigh the costs associated with it. Examples of criteria are observed: mobility of production factors, openness of the economy, scope of mutual trade, synchronization of economic cycles, diversification of production and consumption, price and wage flexibility (these are indicators of structural convergence). The indicator of similarity in inflation is also included in structural indicators. The higher the level of fulfilment of the criteria means higher possibility that the benefits of membership outweigh the costs. Other criterion, the integration of financial markets, may temporarily mitigate adverse shocks. A high degree of political integration is crucial for the existence of a monetary union and also creates a precondition for an additional criterion for the proper function of a monetary union that is the fiscal integration.

2 The summary of current and proposed monetary unions

There are few existing currency unions in the world:

- Economic and Monetary Union of the European Union. Sixteen states of the European Union use the single currency EURO.
- Central African and Monetary Community (CAEMC). The CFA franc is a currency of six independent states, it is used by Cameroon, the Central African Republic, Chad, the Republic of the Congo, Equatorial Guinea and Gabon and is issued by the Central African Economic and Monetary Community. CAEMC's objectives are the promotion of trade and common market, greater solidarity among people and promotion of under-privileged countries and regions.
- West African Economic and Monetary Union (WAEMU). The CFA franc is also the currency of eight independent states (Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo) and it is issued by the West

African Economic and Monetary Union. This monetary union was formed in 1994.

The CFA franc zone comprises 14 African countries grouped into two monetary unions, the CAEMC and WAEMU. Both the Central African currencies and the West African currencies are called the “CFA franc” but are not legal tenders in other region.

- The CFP franc zone (CFP franc is used in French Polynesia, New Caledonia, Wallis and Futuna). It is issued by the Overseas Issuing Institute.
- Eastern Caribbean Currency Union of the Organisation of Eastern Caribbean States (OECS). This monetary union was created in 1981. The common currency is the East Caribbean dollar, which is used in Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines. The currency is issued by the Eastern Caribbean Central Bank serving as a single monetary authority for 8 countries.

In context of a wider definition of monetary unions, other monetary groupings may be also included. These are mainly the monetary unions, when one state uses the currency of another state (or monetary union). Here are few examples: the Swiss franc is legal tender also in Liechtenstein, the Australian dollar is used in Australia, Kiribati, Nauru, and Tuvalu, the The United States dollar is used except the United States by other states: Palau, Micronesia, the Marshall Islands, Panama (alongside the Panamanian balboa), Ecuador, El Salvador, Timor-Leste, the British Virgin Islands and the Turks and Caicos Islands. (US dollar is also used unofficially in some states. This is called a unilateral dolarization.) Several countries use also the single currency of the Economic and Monetary Union of the European Union. The euro is the official tender in Kosovo and Montenegro, although these countries are not members of the euro area. They decided unilaterally to use the euro as their official currency. Other countries, where the euro is used are Monaco, San Marino and Vatican. They use the euro under the agreements with the euroarea and they have the right to mint its own eurocoins. Andorra also uses the euro as its currency, but this country doesn't mint its own eurocoins.¹ Another type of monetary grouping is when the tender of one country serves as the official tender in all countries of the group. Examples are Brunei and Singapore, where the official tenders are Brunei dollar and the Singapore dollar, respectively. There are also many examples of groupings, where currencies of some countries are linked together through fixed exchange rates. Many countries have also their currencies pegged to the euro and US dollar.

There is a lot of effort to create new monetary unions in the world. A brief list of the unions is:

- in Asia
 - Monetary union of Gulf Cooperation Council
 - Monetary union of Association of South East Asian Nations
 - Monetary union of East Asia (Japan, China, South Korea)
 - Monetary union of South Asian Association for Regional Cooperation

¹ There are also Non-European territories of members of the euro area, which are not part of the EU using the euro. Some examples are Mayotte, Saint Pierre and Miquelon etc.

- in America
 - Monetary union of North American Free Trade Agreement (NAFTA)
 - Monetary union of Caribbean Single Market and Economy (CARICOM)
 - Monetary union of Union of South American Nations
- in Africa
 - Monetary union of African Union
 - Monetary union of East African Community
 - Monetary union of Common Market for Eastern and Southern Africa
 - West African Monetary Zone
 - Monetary union of Southern African Development Community/Southern African Customs Union

3 Monetary union of Gulf Cooperation Council

3.1 Gulf Cooperation Council

Gulf Cooperation Council (GCC) was created in the year 1981. It is a trade block (a type of intergovernmental agreement, where regional barriers to trade (tariffs and non-tariff barriers) are reduced or eliminated among the participating states). The member states are six Arab states of the Persian Gulf: The Kingdom of Bahrain, Kuwait, The Sultanate of Oman, Qatar, The Kingdom of Saudi Arabia and the United Arab Emirates. The global significance of this area stems from its hydrocarbon resources.

These countries have plenty of economic and social objectives. The basic objectives are to support coordination, integration and inter-connection among member states in all fields, and also strengthening ties among their people, formulating similar regulations in various fields such as economy, finance, trade, customs, tourism, legislation, administration, fostering scientific and technical progress in fields of industry, mining, agriculture, water and animal resources, establishing scientific research centres, setting up joint ventures, and encouraging cooperation of the private sector. One of the objectives of the grouping is just a creation of the monetary union. So, this idea of common currency has been in existence since the establishment of the GCC. This grouping has slowly continued to deeper economic integration. A customs union was established in the year 2003. A common market of GCC was launched on January 1, 2008. It grants national treatment for all firms and citizens in any other country of GCC, and it removes all barriers to cross country investment and services trade. So, a growth of capital flows occurs in this region. A labour can move relatively easy among these countries. The GCC Committee for Financial and Economic Cooperation also set out a timetable for the establishment of a common currency by 2010 as its prime plan.

3.2 Selected characteristics of GCC countries (with focus on economic characteristics and OCA theory criteria)

The total area of GCC is 2 672 700 km². The population of GCC is 36,2 million. The GCC members possess 40% of proven oil reserves and 20% of world gas reserves. Saudi Arabia has the largest proven oil reserves in the world (estimated at 264,2 bb. in

the year 2006). Energy sector dominates in the GCC countries, so the economies are relatively synchronized. But they seek to reduce the dependence on oil and to develop non-oil sectors (especially Bahrain and the UAE) using the fiscal policy. Monetary policy focuses on the stability of the exchange rate and inflation, fiscal policy on other economic objectives, such as growth, equity and employment. The countries are implementing policy reforms to accelerate a growth of non-oil sectors because the fiscal policy has been constrained by the dependence of government revenues on oil prices.

Countries share a common social and political history. The official language of all members is Arabic and official religion of all members is Islam. Foreign labour accounts for at least a half of the workforce in each country. They have flexible labour markets in which nominal wages can adjust and there is complete mobility of factors among these countries (M. S. Khan, 2009).

Gross domestic product (GDP) per capita is a measurement of the wealth in an economy. In accordance with the data shown in Table 1, Qatar occupies the first place among 180 monitored countries in the world. The lowest product per capita among these states is achieved by Saudi Arabia. It is the richest country among GCC countries but it has also the highest population within GCC countries. The GCC countries are classified as developing high income countries.²

Table 1
GDP based on purchasing-power-parity per capita, current international dollars (for 2009=estimates)

Country	2008	2009
Qatar	86 008,091	87 716,726
Bahrain	34 661,797	35 561,241
Kuwait	39 914,890	38 875,587
United Arab Emirates (UAE)	38 893,684	38 283,571
Oman	24 673,945	25 829,281
Saudi Arabia	23 813,912	23 387,632

Source: International Monetary Fund (IMF).

By assessing the suitability of joining a monetary union, some criteria play an important role. The degree of openness of the economy belongs to these criteria. The higher degree of openness means more appropriate entry into a monetary union. The ratio: (export + import) / GDP can be used as an indicator of openness. If oil prices decrease, exports will decrease and conversely, if oil prices increase, exports will increase as well. So, there can be used also the ratio: import / GDP. As shown in the Table 2, the degree of openness differs among the countries. The highest degrees have been achieved by Bahrain and United Arab Emirates.

² A high-income economy is defined by the World Bank as a country with a Gross National Income per capita of 11 906 USD or more in 2008.

Table 2

The degree of openness of GCC economies, percentage (import / GDP, rounded to three decimal places, for 2009=estimates)

Country	2007	2008	2009
Bahrain	66,692	73,931	56,815
Kuwait	27,918	22,392	29,074
Oman	45,389	38,701	32,483
Qatar	38,147	38,807	54,246
Saudi Arabia	37,982	38,217	48,485
UAE	82,418	82,930	86,098

Source: IMF, own calculations.

Intra GCC trade is also an important indicator. It grows over time. The high level of mutual trade increases the expectation that the benefits of membership in a monetary union outweigh the costs associated with it. Table 3 doesn't show very high range of mutual trade. Among the states of the euro area the shares are much bigger. It is connected with the less developed non-oil sector and other characteristic features of GCC economies and of this grouping (for example smaller size of the GCC). The degree of integration is also an important factor. The creation of the monetary union contributes to the reinforcement of bilateral trade. It removes the barriers of international trade, namely the national currencies. Monetary union has lower trade barriers, more trade and higher welfare (A.K. Rose, E. van Wincoop, 2001).

Table 3

Intra GCC trade as a share of total trade, percentage (computed as: (intra GCC exports + intra GCC imports) / (total GCC exports + total GCC imports), rounded to one decimal place, exports are not including oil)

Year	2004	2005	2006
	13,5	14,1 *	15,5*

* not including Kuwait

Source: GCC: A Statistical Glance, own calculations.

The countries of the GCC are structurally similar. In the case of existence of asymmetric economic shocks among member countries, membership in a monetary union can become restrictive or the reverse country must have flexible adaptive mechanisms. All countries in this area are world-significant producers of oil and gas. If a sudden increase in oil and gas prices occurs, the shock will be beneficial to all countries of the region. Symmetric shocks may also be associated with asymmetric effects. Countries do not always react the same way on the same economic shock. It depends on the socio-economic structures, rules and legislative, traditions in the labour market, external debt and many other factors. Compared with the EU, these countries represent a homogeneous block in terms of history, culture, and economic structure, monetary and fiscal trends. They show a high degree of monetary and fiscal convergence. These countries face similar economic and social challenges (D. Hanna, 2006). Oil accounts for about a third of the GDP in countries of GCC, three-quarters of its government revenues and also three-quarters of its exports. There is also lack of

other sources of revenues. This has the effect that the economies are relatively synchronized.

Countries of GCC have less diversified economies, with dominance of the petroleum and gas sector in all economies. However, in the future it will be necessary to develop non-oil sectors (particularly in Oman and Bahrain, which are most vulnerable to the depletion of oil reserves). The flexibility of GCC labour markets could also be reduced in regard to increasing the number of national workers in the non-oil sectors and increasing their wage bargaining power. This could reduce the ability of some countries to adjust the shocks through the changes of nominal wages.

3.3 Creation of the GCC monetary union and current levels of convergence criteria's fulfilment

The adoption of a common currency is the ambitious objective towards economic integration. Four states of GCC (Saudi Arabia, Bahrain, Kuwait and Qatar) signed a pact in Riyadh to adopt a common currency. The part of the project is also establishment of the common central bank in Riyadh. Oman has already withdrawn from the project of the monetary union, but it should join the monetary union in a future. The United Arab Emirates refused to join because of the seat of the central bank. It is a protest against the dominant position of Saudi Arabia. The withdrawal of the United Arab Emirates raises questions about the Gulf governments' ability to overcome old political obstacles, which hinders economic and financial integration. Saudi Arabia has the strongest and the richest economy in the region and has the largest population. The United Arab Emirates, however, have the largest financial sector. They have the largest number of banks, the biggest assets and the largest deposits in the region. The United Arab Emirates have approximately 50% share in the financial transfers of GCC.

The Supreme Council in Abu Dhabi (December 2005) approved the following criteria for achieving economic convergence and financial and monetary stability. The GCC Secretariat has said, that the Maastricht criteria will be used for this monetary union:

1. Monetary convergence criteria include: inflation rates, interest rates and sufficiency of the foreign cash reserves.
2. Financial convergence criteria include: an annual deficit ratio of the government finance to GDP and a ratio of the public debt to GDP.

The requirements for entry are that a country's budget deficit is less than 3% of GDP and the public sector debt is less than 60% of GDP. In addition, each country will be required to have currency reserves covering four month imports. Inflation must not exceed the weighted average of the six countries' inflation rates by more than 2%. Interest rates must not exceed the average of the lowest three countries by more than 2%. The question is whether these countries can meet these criteria in a sustainable way. The significant slump of oil prices can cause problems with budget deficits and jeopardize cooperation. These economies have been already somewhat diversified; less progress has been made on diversifying the source of government revenues.

Inflation rates in the region vary dramatically. As shown in the Table 4, differences among countries are large, so there may be problems with the fulfilment of the criterion (particularly Qatar and UAE that have the highest rates of inflation).

Table 4
Consumer Price Index for GCC States during 2001-2009, annual percent change (for 2009=estimates)

Year	Kuwait	Qatar	Oman	Kingdom of Saudi Arabia	Bahrain	United Arab Emirates
2001	1,4	1,4	-0,8	-1,1	-1,2	2,7
2002	0,8	0,2	-0,3	0,2	-0,5	2,9
2003	1,0	2,3	0,2	0,6	1,7	3,2
2004	1,3	6,8	0,7	0,4	2,2	5,0
2005	4,1	8,8	1,9	0,6	2,6	6,2
2006	3,1	11,8	3,4	2,3	2,0	9,3
2007	5,5	13,8	5,9	4,1	3,3	11,1
2008	10,5	15,0	12,6	9,9	3,5	11,5
2009	6,0	9,0	6,2	5,5	3,0	2,0

Source: IMF. *World Economic Outlook*.

Fiscal deficits have been absent since the start of the oil boom in 2003 and now are re-emerging. Table 5 shows the fulfilment of three convergence criteria in 2004. Bahrain did not fulfil the criterion of currency reserves (also according to recent data from 2006) and Saudi Arabia did not fulfil the ratio of the public debt to GDP.

Table 5
Budget balance, public debt and currency reserves of GCC, 2004

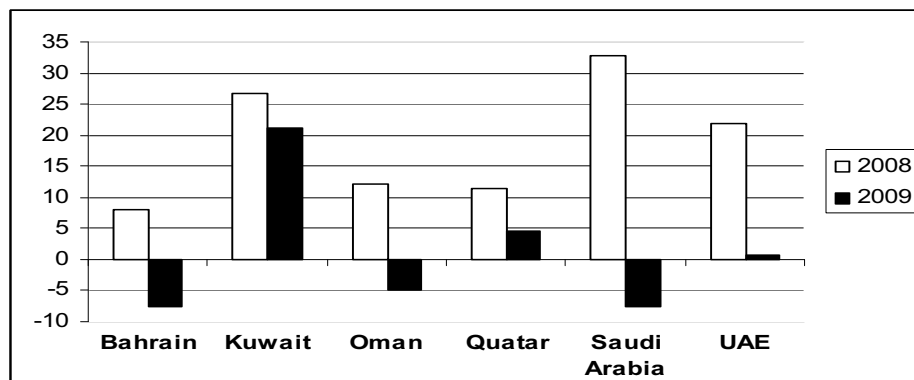
	Budget surplus (% of GDP)	Public debt (% of GDP)	Currency reserves Months of Import cover
Bahrain	0,7*	34,3*	3,8
Kuwait	19,1	21,1	8,5
Oman	4,8*	13,1*	5,5
Qatar	8,6*	34,6*	6,6
Saudi Arabia	10,4*	65,3*	8,0
UAE	18,3	8,4	4,1

* Central Government

Source: IMF/IIF estimates, SCB Global Research calculations.

There are no criteria dealing with volatility of oil prices. Price drop may cause problems of budget deficits before the creation of the monetary union. According to the projections of the IMF, some countries in 2009 show deficits or their surpluses are significantly reduced compared with the previous year as shown in Figure 1.

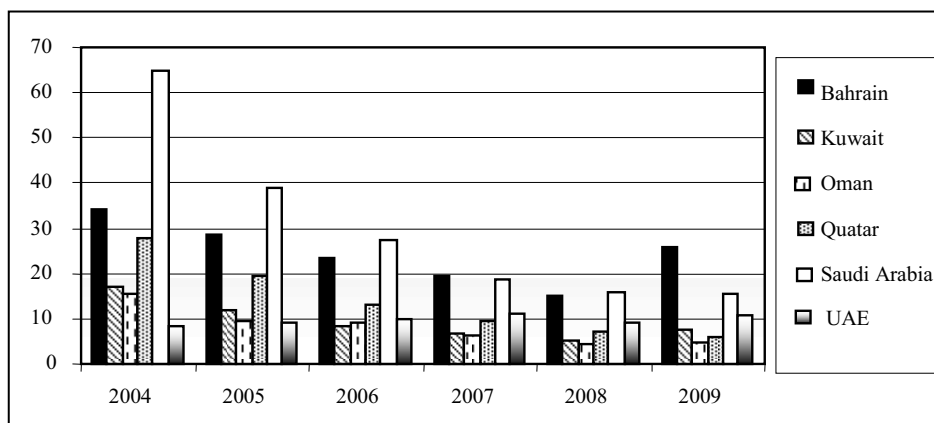
Figure 1
Central Government Fiscal balance, in percents of GDP (for 2009=estimates)



Source: IMF. *Regional Economic Outlook*.

Figure 2 illustrates the longer development of total government debt in GCC countries. As shown in the Figure, all countries meet the criterion that the debt should not exceed 60% of GDP with the exception of Saudi Arabia in 2004.

Figure 2
Total Government Debt 2004-2009, in percent of GDP (for 2009=estimates)



Source: IMF. *Regional Economic Outlook*.

The values of the fiscal criteria were set to reflect economic growth and inflation in the euro area and to ensure macroeconomic stability. Trends in growth and inflation in GCC states are different and these criteria don't take into account the significance of oil revenues to the fiscal trends in GCC. These revenues significantly affect the budget and debt levels.

From an economic point of view, the region has already overcome some of the obstacles to a single currency. The countries have already pegged their currencies to the dollar (except for Kuwait). Emphasis should be placed also on the sustainability of the

monetary union. This monetary union and also its ability to face symmetric and asymmetric shocks will be influenced by many factors. It is noteworthy to repeat these three factors. It is a reduction of hydrocarbon resources that will lead to a reduction in the fiscal flexibility. Secondly, the process of diversification continues at different speeds in different countries. Thirdly, there are also different advances in demographic and labour market pressures among the countries. These may lead to reduced flexibility in the labour market.

The creation of the monetary union has been planned in 2010. This is not likely to happen. The problem is an unformed infrastructure and a lack of necessary regional institutions. The institutional problem can be the biggest obstacle, especially in terms of setting up a single monetary authority. Complications are, of course, the political disagreements in the region. To create a monetary union enough political will is also important, not only the fulfilment of economic criteria.

3.4 Brief look at the choice of a new currency's exchange rate regime

Countries of GCC have pegged their currencies to the US dollar since 2003. Kuwait announced that it moved from the dollar peg to an undisclosed currency basket in May 2007. But this country wants to join the monetary union. A new common currency will be pegged to the US dollar too. This can be changed after the introduction of the common currency. The member countries can choose the pegging to one or more currencies or floating depending on the requirements and conditions in the future. The possibilities (proposed by the IMF) are the following: dollar peg, basket peg, managed float and oil-peg (pegging to the export price of oil).

The choice of exchange rate regime of the common currency is related to the structural characteristics of GCC economies, such as dominance of oil sector. Important challenges for these countries are further development of non-oil sectors to employ growing national labour force (however, the oil sector will play a key role very long in all countries, except for Bahrain and Oman). In relation to the future diversification of the economies will be required for greater exchange rate flexibility. And also increased trade openness, capital mobility, foreign direct investment can cause deflection from the dollar peg. More flexible exchange rate regime can serve as an instrument of an adjustment to shocks (particularly real domestic and external shocks).

The peg to the US dollar has contributed to the macroeconomic stability, facilitation of trade and financial transactions and it is easy to administer. Disadvantage of the dollar peg is that it imports monetary policy of the United States and the GCC countries follow the US interest rate policy. So it ties them to inappropriate monetary policies (this can also be the case of a basket peg). Countries are also not protected against imported inflation.

Conversely, in the case of managed floating countries can use monetary policy corresponding their economic cycle. It allows countries to face the real shocks easily than under a fixed exchange rate regime. But this regime is associated with some uncertainty in international transactions and complicates business planning and it is also associated with a risk of high exchange rate volatility. Large fluctuations in oil prices

could cause volatile exchange rate and this could cause larger fluctuations in non-oil sectors and a more volatile inflation. Because the role of interest rates is limited in these countries (i.e. spending decisions are not sensitive to changes of interest rate), dollar peg is currently more appropriate than managed floating.

However, in order to ensure competitiveness of non-oil sectors, a certain level of exchange rate flexibility is desirable as the economies become more diversified. So, in the future, the dollar peg may weaken the competitiveness of non-oil sectors. This flexibility may provide a basket peg (Moshin S. Khan, 2009). But this regime also rules out the possibility of own monetary policy, the interest rate follows a basket of interest rates and does not solve the problem of imported inflation. One option could be a pegging the currency to the SDR.³ Another option is pegging the currency to a basket composed of the euro and dollar. These two currencies account for a large portion of international trade and financial transactions. Oil peg is often suggested for small open economies specialised in production of mineral commodities. But the GCC countries cannot be considered as small open economies (prices of oil cannot be regarded as exogenous). There are also more disadvantages connected with this regime, for example, the high oil prices would increase the cost of other exports and thus jeopardize the diversification of economies. There is also a proposal, that the new currency could include gold (gold would be included in the currency basket). Saudi Arabia is the largest and the richest economy in the GCC and disposes of substantial gold reserves.

So, it can be said that the dollar peg seems to be the best choice at the beginning of GCC monetary union. However, a more flexible exchange rate regime can be desirable in the future. The choice depends on the preferences and needs of these countries. The chosen exchange rate regimes have to be compatible with an overall policy framework and it is also necessary to establish some institutional factors. So, the higher exchange rate flexibility cannot be achieved immediately (see also O. Celasun, 2003).

4 Conclusion

There are many indicators for assessing the suitability for entry into a monetary union. This paper is focused on certain OCA theory criteria. Some criteria have been fulfilled, some less in the case of GCC countries. These countries are structurally similar and they have achieved high degree of monetary and fiscal convergence. Moreover, the growing integration among the countries will help to deal with economic shocks. To create the monetary union, the countries have to increase the level of macroeconomic policy harmonization and create an independent central bank (B. Kamar, S. Ben Naceur, 2007). This means that the countries have to address the institutional framework of a monetary union which still suffers from many loopholes. Also the political aspect, namely the sufficiency of political will, plays a key role.

³ It is composed of major currencies: euro, pound sterling, yen and the US dollar. In the case of GCC countries, the stability gains connected with the dollar peg outweigh the stability gains connected with the SDR peg (G. Abed, S. Nuri Erbas, B. Guerami, 2003)

The single currency can bring many benefits to the countries. However, some of them will come after a longer time. The monetary union will contribute to the economic integration of the region and to the development and the integration of the GCC capital markets and also help to facilitate trade and financial services among countries. The effort of the countries to maintain low budget deficits, debts and low inflation (after the development of the non-oil sectors) will provide the macroeconomic stability in the region and attract investments. So they could achieve an increase in growth and accelerate their development.

The new common currency will be pegged to the US dollar. A choice of an exchange rate regime in the future will depend on economic and political considerations of GCC countries. There are many challenges for the sustainability of this monetary union. Countries should make reforms and develop non-oil sectors to make their economies more diversified. In connection with the reduction of oil reserves, economies of this grouping become more heterogeneous, which increases the likelihood of asymmetric shocks and they will lose their sources of revenues. The countries could face huge public deficits, unless they find new sources of revenues. The lack of income and the need to adapt to asymmetric shocks through fiscal policy will deepen public deficits and can threaten the monetary union. With the increasing number of national workers in non-oil sectors, the labour markets of GCC countries also become less flexible.

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